SPEAKMAN LAW

Tax Rules for Related Party Debt Financing

Tax Reductions Achieved by Multi-Nationals

Media attention has highlighted the extent to which large multi-nationals have historically escaped New Zealand tax on their earnings here. For example, a 2014 article published in the Herald lamented the small collection of income tax in New Zealand gained from 20 large multi-national corporates. The New Zealand Government reputedly collected income tax of only $1.8m whereas over $500m of income tax ought to have been collected from them based on their earnings here.

How is this possible? It is made possible through the tax practice of shifting profits from one country to another. High priced debt financing from an overseas parent to its New Zealand subsidiary is one means of achieving this.

Cross Border Profit Shifting

Complicated tax rules seek to combat the practice of shifting profits of a New Zealand subsidiary to its overseas parent. At the core of these are related party debt financing rules that apply to excessively geared companies.

Related Party Debt Financing

For an overseas parent of a New Zealand subsidiary, debt funding is largely substitutable for equity funding and is usually preferred for the tax result it delivers. Should an overseas parent wish to do so, it may choose to fund its subsidiary wholly by debt. Tax protective rules are therefore needed to ensure that interest deductions flowing from the debt financing do not inappropriately shift the tax burden on the subsidiary's local earnings from New Zealand to the country in which its parent is resident.

Thin Capitalisation Rules

Thin capitalisation rules are the primary protective tax measure to counter this result. These rules deny a New Zealand subsidiary a deduction for interest to the extent the subsidiary is excessively geared (the rules set the limit as 60% debt and require the subsidiary debt/equity ratio to be no greater than 110% than that of the worldwide group).

Until only two years ago, a gaping hole remained in these rules. The hole was the tax planning opportunity of attaching an artificially high interest rate to related party debt ("**High Priced Related Party Debt**").

High Priced Related Party Debt

Countermeasures against the use of High Priced Related Party Debt were introduced nearly 2 years ago. These entailed a specific tax protection rule known as the **Restricted Transfer Pricing Rule**. This rule responded to the failure of existing transfer pricing rules as a means of guarding against tax driven related party loan arrangements.

Notwithstanding these countermeasures, two features of the Restricted Transfer Pricing rule have, until now, remained unsatisfactory. The first is a de minimus threshold, below which a breach of the thin capitalisation protections has been ignored. The second has been the practical difficulty in applying the restricted transfer pricing rules.

Legislative Response Addresses these Features

Pleasingly, recent amendments to the Income Tax Act address these features. They neatly effect the needed tax protection against related party cross border financing arrangements. The first of these two amendments is to remove the de minimus threshold so that the Restricted Transfer Pricing Rule applies to all related party debt. The second amendment is to facilitate a practical method of determining a borrower's credit rating so as to allow an appropriate interest rate for related party debt to be identified (against which an existing rate can be referenced to ascertain whether or not it is artificially high). An "optional credit rating method" serves this purpose. In practice, its usefulness has to date been limited by its non-applicability to secured debt. That limitation has now been removed. Consequently, the optional credit rating method is now available for related party debt whether it is secured or unsecured. This is a thoroughly welcome extension to the rules.

These two amendments add to the protections intended by the tax rules for related party debt financing. They are timely in the present environment and are thoroughly recommended.